FEBRUARY 2007
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APRIL 2007
MAY 2007
JUNE 2007
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AUGUST 2007
SEPTEMBER 2007
OCTOBER 2007
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JANUARY 2011
FEBRUARY 2011
MARCH 2011
14,000
13,000
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10,000
9,000
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Dow Jones Industrial Average
TRACKING THE CREDIT CRISIS
In 2007, the US experienced a financial crisis the likes of which have not been experienced since the Great Depression. What is now being termed the "Great Recession" was a global financial crisis of unprecedented size, speed, and interconnectedness. Even as this is written, around the world are still dealing with the aftershocks, and rumors of double-dip recessions loom while the international financial system slowly recovers.
What caused this crisis? Put simply, it was a chain reaction that began with banks and mortgage companies making housing loans to homeowners who could not afford them, and who defaulted when the housing market began to contract. The crisis then spread through the banking system and internationally through the complex securities that had been created from mortgages and instruments. This triggered collapses in credit markets, asset prices and eventually in global economic activity.
This timeline traces the development of the crisis from the banning of the housing bubble through the unprecedented trillions of dollars being guaranteed and invested by governments in the US and in Europe. Government. To provide a in and light on the complexity and enormity of this important moment in financial history as it continues to unfold.
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KEY TO COLORS
Residential subprime, mortgage, and housing
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Real estate investments
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IMPORTANT TERMS
CREDIT DERIVED. A general term that describes financial instruments whose underlying source of credit is derived from a pool of loans. Typically, the credit quality and performance of the derivative instrument depends on the performance of the underlying loans. Examples include mortgage-backed securities (MBS) and collateralized debt obligations (CDO).
DERIVATIVE. A contract between two counterparties whose value is based on the performance of an underlying financial asset, index, or security. These contracts can be used to trade risk and to speculate.
CREDIT DEFAULT SWAP (CDS). A financial swap agreement that the seller of the CDS will compensate the buyer (usually the creditor of the reference loan) in the event of a loan default (or other credit event). The buyer of the CDS makes payments to the seller up until the end of the contract, or until a credit event occurs. CDS are used to transfer the credit exposure of fixed income products between parties. CDS also provide a means to speculate on changes in the credit quality of companies or countries.
COLLATERALIZED DEBT OBLIGATION (CDO). A security backed by a pool of bonds, loans and other assets. CDOs do not specialize in one type of debt but are often backed by different types of debt and are typically structured to have different risk profiles called tranches. Investors can choose a tranche according to their risk appetite. Senior tranches are generally considered safer because they have first claim to the cash flows from the pool, and junior tranches are considered more risky because they offer lower levels of protection and will be the first to absorb losses. Losses are applied in order of seniority, such that junior tranches are first to experience losses after the equity portion of the CDO is exhausted. Synthetic CDOs invest in credit default swaps or other derivatives instead of purchasing cash bonds.
MORTGAGE. A financial contract between a lender and a borrower where the borrower receives money to buy a property. The borrower promises to pay back the money, usually in monthly payments of principal and interest, over a set number of years. The lender can foreclose on the property if the borrower defaults on the loan.
MORTGAGE-BACKED SECURITY (MBS). A security backed by a pool of mortgages. Investors receive payments out of the monthly mortgage payments made by homeowners. MBS can be issued by government agencies or by private companies such as banks. Mortgages were structured to bring varying levels of risk and return to investors. Most MBS were issued and traded by specialized financial institutions or large banks. Once these loans were packaged and sold as MBS, the originating lender typically did not retain the loan on its books.
MORTGAGE BROKER. An individual or company that matches borrowers with lenders. Brokers usually work with many lenders and receive a commission for originating a loan.
MORTGAGE ORIGINATOR. The lender who funds a mortgage loan.
NEGATIVE EQUITY. When the amount owed on a mortgage is greater than the value of the property. Also known as being "underwater" or "upside down."
SECURITIZATION. The process of pooling financial assets and selling them through a financial instrument.
SHORT SELL. To sell a security that the seller does not own, with the hope that the price will decline, allowing the seller to buy it back at a lower price and profit from the difference.
SUBPRIME. Refers to borrowers with lower credit scores who have difficulty obtaining loans at the lowest interest rates. Subprime borrowers are considered more likely to default on their loans.
TRANCHE. A financial instrument that is one of several similar securities issued at the same time, but with different risk, return, or maturity characteristics.
UNDERWRITING. The process of evaluating the risk of a loan application and deciding whether to approve it and on what terms.
VALUE AT RISK. A statistical measure used to estimate the potential loss in value of a portfolio over a specific time period and at a given confidence level.
THE BUBBLE BURSTS:
The Origins of the Credit Crisis
Between 2002 and 2007, $7 trillion worth of home mortgages were issued in the US. Lenders made loans to borrowers with poor credit histories, and to those who could not afford to make the payments. Many of these loans had adjustable rates that reset after an introductory period. Mortgage brokers earned fees for originating loans, but did not usually keep the loans on their books. Instead, they sold them to investment banks, which packaged them into mortgage-backed securities (MBS) and collateralized debt obligations (CDOs). These were then sold to investors around the world. By 2006, the total value of outstanding subprime mortgages was $1.3 trillion. Housing prices peaked in mid-2006 and began to decline. Many borrowers found themselves unable to refinance their loans or sell their homes for enough to repay their mortgages. As defaults rose, the value of mortgage-backed securities fell, causing losses throughout the financial system. Banks, which had borrowed heavily to buy these assets, were forced to write down billions of dollars in losses. Some failed outright, while others required government bailouts to survive. The crisis quickly spread from the housing market to the broader economy, leading to a severe credit crunch, plummeting stock markets, and the worst economic downturn since the Great Depression.
TOXIC ASSETS: Passing and Exporting Subprime Debt
Financial institutions around the world bought and sold mortgage-backed securities and collateralized debt obligations (CDOs) backed by US subprime mortgages. Many of these assets were rated AAA by credit rating agencies, making them appear safe. However, as defaults rose, the value of these securities plummeted. Banks and investors found themselves holding assets they could not sell at any reasonable price. This uncertainty about who held the toxic assets led to a freeze in interbank lending, as institutions became reluctant to lend to one another for fear they might not get their money back. The result was a global credit crunch that threatened the entire financial system.
LEHMAN: A Turning Point
Lehman Brothers was about to go bankrupt. Treasury officials and Federal Reserve officials had been working around the clock to find a buyer for the firm, but no deal had been struck. The Bush administration's refusal to bail the same investment bank out of trouble was a turning point in the crisis. Lehman's failure caused panic throughout the financial system. Credit markets froze, and a stock market crash of unprecedented magnitude followed. Lehman's bankruptcy was the largest in US history, with $639 billion in assets.
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CREDIT RATING AGENCIES: A Conflict of Interest?
The validity of credit ratings from agencies such as Standard & Poor's, Moody's, and Fitch Ratings was questioned during the crisis. Many of the mortgage-backed securities and collateralized debt obligations that were at the heart of the crisis had been repackaged assets with complex structures. Investors relied on the ratings agencies' assessments of the risk of these securities, but the agencies had a conflict of interest. They were paid by the issuers of the securities they were rating, creating an incentive to give favorable ratings to secure more business. Critics argued that the agencies' models underestimated the risk of housing market declines and failed to account for the correlation between different types of mortgages. When housing prices began to fall, many highly rated securities were downgraded to junk status, causing massive losses for investors who had relied on the agencies' ratings.
QUANTITATIVE EASING:
A New Monetary Policy
To stave off a crippling recession, a country resorts first to lowering interest rates to stimulate borrowing and investment. But what if interest rates are already near zero? In such a situation, a central bank can resort to quantitative easing, which means buying assets to push through the economy. Quantitative easing is a relatively new monetary policy tool that central banks have used in response to the financial crisis. The Federal Reserve has purchased trillions of dollars in mortgage-backed securities and Treasury bonds since 2008. The Bank of England has also used quantitative easing, and the European Central Bank has purchased government bonds from countries in financial distress. Quantitative easing is controversial. Critics argue that it could lead to inflation in the future, and that it may not have been necessary in the first place. Supporters argue that it has helped to prevent a much worse crisis. Only time will tell which side was right.
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